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No. 372

In the Supreme Court of the United States

OCTOBER TERM, 1960

GEORGE S. MUNSON AND KATHARINE S. MUNSON,
PETITIONERS

v.

EDGAR A. MCGINNES, INDIVIDUALLY AND AS UNITED STATES DISTRICT DIRECTOR OF INTERNAL REVENUE FOR THE INTERNAL REVENUE DISTRICT OF PHILADELPHIA, PENNSYLVANIA

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the District Court (Pet. 1a–4a)[1] is reported at 178 F. Supp. 380. The opinion of the Court of Appeals (Pet. 6a–14a) is not yet reported.

JURISDICTION

The judgment of the Court of Appeals (Pet. 15a) was entered June 8, 1960. The petition for a writ of certiorari was filed August 31, 1960. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254(1).

QUESTION PRESENTED

Whether an amount expended as attorney fees in connection with litigation which resulted in the realization by the taxpayer of additional taxable capital gain on the sale of a capital asset was properly applied as a reduction of such taxable capital gain, or whether it was deductible from gross income by the taxpayer as "ordinary and necessary" expenses paid or incurred during the taxable year "for the production or collection of income" within the meaning of Section 212 of the Internal Revenue Code of 1954.

STATUTE INVOLVED

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):

> SEC. 212. EXPENSES FOR PRODUCTION OF INCOME.
>
> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
>
> (1) for the production or collection of income;
>
> (2) for the management, conservation, or maintenance of property held for the production of income; or
>
> (3) in connection with the determination, collection, or refund of any tax.

STATEMENT

This is a suit for refund of income taxes alleged to have been erroneously or illegally collected from the taxpayer, George S. Munson,[1] for the year 1954. In

[1] Katherine S. Munson is a party only because she filed a joint return with her husband.

dispute is the manner in which the taxpayer is entitled to deduct a $110,000 attorney's fee in the computation of his income tax for the year 1954. The circumstances under which the fee was paid, set forth in the taxpayer's claim for refund and recognized by the Government as correct, are as follows:

The fee was paid for professional services in winning a litigated controversy about a sale of the stock and assets of the Williamsport Wire Rope Company to the Bethlehem Steel Company. In 1936 Bethlehem owned bonds of Williamsport which were in default. Taxpayer owned a substantial amount of Williamsport stock. Bethlehem caused Williamsport to be placed in receivership and the mortgage to be foreclosed. With Williamsport thus embarrassed, the taxpayer and the other Williamsport stockholders accepted an offer of Bethlehem to buy their stock. The receiver then sold the Williamsport assets to Bethlehem, and Bethlehem thereafter completely liquidated Williamsport. (Pet. 7a.)

A few years later former Williamsport stockholders, among them the taxpayer, petitioned the receivership court asking that the matter be reopened, that the scheme by which Bethlehem acquired the Williamsport assets be declared fraudulent, and that the assets be traced, identified and returned to the former Williamsport stockholders. (Pet. 7a.)

The court found that the sales of Williamsport stock to Bethlehem and the acquisition of Williamsport assets by Bethlehem had resulted from fraud and that Bethlehem should be declared constructive trustee of such stock and assets for the defrauded Williams-

port stockholders. *Guaranty Trust Co.* v. *Williamsport Wire Rope Co.*, 107 F. Supp. 759 (M.D. Pa.). Pending disposition of a motion for new trial, Bethlehem and the former stockholders agreed to a settlement of the entire controversy. The court approved the proposed settlement, vacated judgment, filed a second opinion, and entered judgment accordingly. 107 F. Supp. 762. The court stated that the administration of the Williamsport receivership had been so fraudulent as to warrant setting aside the sale but that Bethlehem, although benefitting from the fraud, had not been party to it. The remedy decreed was the payment of an additional $6,000,000 by Bethlehem to the former Williamsport stockholders. To accomplish this, Bethlehem was ordered to deposit both $6,000,000 and the certificates of Williamsport stock it had acquired from the former stockholders with the court so that the former stockholders might be identified and the $6,000,000 properly allocated among and distributed to them. The share of the fund allocated and paid to taxpayer was approximately $220,000, out of which he paid the $110,000 counsel fee which is the subject of the present controversy. (Pet. 7a–8a.)

In his 1954 income tax return taxpayer treated the full $220,000 as additional consideration for his Williamsport stock, from which he realized long term capital gain, and deducted the $110,000 counsel fee from ordinary income as "an ordinary and necessary [expense] paid or incurred during the taxable year * * * for the production or collection of income" under Section 212(1) of the 1954 Internal Revenue Code. The Commissioner disallowed the deduction and

treated the fee as an offset reducing the capital gain realized on the sale of stock. The taxpayer paid the resulting deficiency and in due course brought this suit for refund. (Pet. 8a-9a.) The District Court denied the claim (Pet. 1a–4a) and the Court of Appeals affirmed (Pet. 6a–14a).

ARGUMENT

The Court of Appeals held that the counsel fee in question, as an expense of modifying the original terms of sale, was incurred as an essential incident of a capital transaction in the disposition of property and was the kind of selling expense which must be capitalized and offset against the proceeds of sale in determining the taxpayer's capital gain, rather than deducted as an ordinary and necessary expense incurred for the collection of income within the meaning of Section 212(1) of the Internal Revenue Code of 1954. The decision of the Court of Appeals is well reasoned and, we submit, correct. The court's reasoning parallels that of the Eighth Circuit in *Davis* v. *Commissioner*, 151 F. 2d 441, which required selling expenses to be capitalized.

The petition for certiorari (pp. 9–14) alleges conflict between the decision below and decisions of the Fifth and Ninth Circuits in *Coke* v. *Commissioner*, 17 T.C. 403; affirmed *per curiam*, 201 F. 2d 742 (C.A. 5th); *Naylor* v. *Commissioner*, 203 F. 2d 346; (C.A. 5th); and *Heller* v. *Commissioner*, 147 F. 2d 376 (C.A. 9th); certiorari denied, 325 U.S. 868. Each of those cases is distinguishable on its facts.

In *Naylor* v. *Commissioner, supra,* the taxpayer had given an option to a third party to purchase the taxpayer's stock at its net book value on the date the option was exercised. Upon the purchaser's exercise of the option, the taxpayer employed an attorney to negotiate the amount due under the contract and was allowed to deduct the legal fees. In *Heller* v. *Commissioner,* the taxpayer was similarly allowed to deduct fees paid an attorney in litigation to determine the "cash value" the taxpayer was entitled to be paid for his stock upon declining to participate in a corporate reorganization. In both cases, the sale or disposition was already completed and the terms of payment (book or cash value) fixed; all that remained was the liquidation of the amount due under those terms, a step which the courts viewed as simply a part of the "collection" process. The litigation in this case, on the other, involved an attempt to set aside the original terms of sale because of fraud and recover the stock or reform the contract. The fees were an expense of obtaining entirely new terms of sale, not of liquidating the amount due under established terms.

In *Coke* v. *Commissioner, supra,* the taxpayer incurred legal expenses in a suit to set aside a property settlement with her former husband and to establish her interest in certain community property omitted from the settlement. Under a compromise agreement, the property was sold at a substantial gain over its original cost and a share of the proceeds given to the taxpayer. Viewing the suit as one to recover both the taxpayer's share of the original investment in the property and her share of the accrued "gain", the

court allowed deduction of the expenses attributable to recovering the "gain" as being "collection" expenses. Whether or not that decision was sound, it depended upon the court's viewing the suit as one to require the husband to share with the taxpayer a separate "income" item, namely, the gain that had theretofore accrued to him on the stock. No such characterization of the suit here is possible. The taxpayer was seeking, not to have Bethlehem share with him gains or profits that had accrued to it, but simply to reform the original sale agreement and require Bethlehem either to return the property or pay an equitable price for it.[2]

In pointing out the above factual distinctions between this case and the *Naylor, Heller,* and *Coke* cases, we do not mean to imply that those distinctions are valid bases for differing results. To the contrary, it is our view that the differences are immaterial and the decisions turning on them plainly wrong. Our point is only that, because of those *possible* distinctions, there is not such a square conflict of decisions as to require resolution by this Court at this time. And while the underlying conflict in principle evident in the cases may at some time make clarification by this Court necessary, such review should, we think, be deferred until more meaningful bases for distinguishing between "selling" costs and "collection"

[2] *Ruoff* v. *Commissioner*, 277 F. 2d 222 (C.A. 3), also alleged to be in conflict, was decided by the same court as this case (including two of the same judges) and hence, even if inconsistent (though we submit it is not), does not present an inter-circuit conflict requiring resolution by his Court.

costs have been evolved by the lower courts and a clearer choice can be presented to this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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SEPTEMBER 1960.